TESTIMONY OF
THE HONORABLE CURT L. HÉBERT, JR., COMMISSIONER
FEDERAL ENERGY REGULATORY COMMISSION
ON H.R. 2944
THE ELECTRICITY COMPETITION AND RELIABILITY ACT OF 1999
BEFORE THE
HOUSE COMMERCE COMMITTEE
ENERGY AND POWER SUBCOMMITTEE
OCTOBER 5, 1999

Thank you for the opportunity to appear before you. Chairman Barton's invitation specifically asked my colleagues and me to address "whether there is a need for Federal electricity legislation, and if so, why ...". The letter also requested comment on specific provisions of the Barton Bill and solicited alternate language, if possible.

I have publicly stated on many occasions that I will comment on the need for legislation only if asked. Since, Mr. Chairman, you have done so, I will give you my views to the full extent of my thinking, as it pertains to FERC. I will comment in general on certain provisions in the Bill and will not presume to propose alternate language, as I have had but a few days to read this massive Bill. I will, of course, gladly go into detail in response to questions.

Does FERC need Federal electricity legislation? Not necessarily. For investor owned utilities, FERC has adequate existing authority to create a competitive market. More accurately, I should say allow a competitive market to form. Enough authority at the state level exists to allow competition to spread there and to include publicly owned utilities.

The one area Congress could speak to involves the Federal power marketing agencies, the Bonneville Power Administration and the Tennessee Valley Authority. While I think it desirable to cover that part of the picture, I think Congress can wait until the rest of the country sorts out its restructuring and the affected regions, the Northwest, Southwest and Southeast, have an opportunity to consider the complex issues. The effort involves untangling the transmission from the generation and the financial and legal commitments these agencies may have made. Change also involves the matter of tax exempt financing and the problem of preference customers and the so-called "fence" within which bodies, such as TVA, operate.

For the investor owned side, the economics of the industry already push companies into restructuring. Generation now operates as a true business. FERC has extended market based rates from merchant generators to services traditionally provided by utilities. In Order No. 888, the Commission declared new entry into generation will receive market based rates, for all practical purposes. Transmission, the highway of electricity, will remain regulated and will operate as a utility.

As we saw in other industries, beginning with the airlines, a business and a utility use opposite approaches. A CEO of a business looks at value, innovation and opportunity; a CEO of a utility looks at cost, rate base and rate of return. In visits to my office, officials of integrated utilities have expressed the desire to tackle one or the other – looking for profits in generation or engaging in strategically important transmission. Witness as well some utilities, such as Duke Energy and the Southern Company, buying generation that others, such as New England Power Company and Consolidated Edison Company, sell off. As I wrote in an article in the *Public Utilities Fortnightly* last year, "The fruit of divestiture has ripened."

The next step must come from FERC. Our rate setting encourages utilities to sit still. We all but prohibit companies from engaging in the transmission business. We also keep new investors out. In allowing utilities to recover original cost, less depreciation on facilities about 30 years old, FERC says to a potential entrant, "You cannot afford to buy these facilities for their value." It also tells integrated utilities, "You won't get anything for your assets, so if you sell, you will be asking for shareholder opposition." To cure that, FERC must grant an acquisition adjustment that reflects the economic benefits transmission facilities will bring to the table. On the other side, policies that force sellers to return to ratepayers any gains from a sale negate the good in the acquisition adjustment. FERC and the states must allow shareholders to reap at least half the profits from sale of transmission.

Higher rates of return to reflect greater risk of transmission would encourage restructuring for existing facilities, as would shorter depreciation to account for the likelihood of distributed generation and other technological changes that may render facilities obsolete before the end of their physical life.

Most important, for the future, restructuring, competition and innovation come down to expansion. We have all seen statistics showing transmission investment has declined to a trickle (if not less). Primarily, a pricing scheme that requires all customers to pay for all facilities creates arguments. It leads to controversies. Why should I, an existing customer, pay for a new line, when I have all I need? On the other side, I, as a new customer, want everyone else to supplement my costs, so of course, everyone should contribute to my line!

Business has a simple way of handling new facilities: incremental pricing. Arbitrary as it might seem from a theoretical point of view, making the new customer pay the entire cost of interconnection brings certainty at the least cost. Existing customers can rest assured, once they paid their freight, that a new customer would not saddle them with more. New customers will have to calculate the full cost of their ventures and will plan accordingly. Once they commit to a price, they will see the transaction through. I add here, parenthetically, that incremental pricing will still leave some controversy, when opposition to construction or upgrade stems from other considerations.

All of this, and more, FERC can accomplish by exercising its authority under Section 205 of the Federal Power Act. Since the 1940's, the Supreme Court has held that nothing in the Act binds the Commission to any particular formula, as long as we balance the interests of consumers and utilities. Were we to do that here, we would institute the kinds of incentives and performance based rates that will allow a separate transmission business to form and thrive. A separate transmission business, a "clean break," in the words of the Federal Trade Commission Staff's comments in the RTO NOPR, forms the best foundation for competition in generation and low prices to the customer.

Other impediments to restructuring exist, some of which you correctly blame FERC for, even apart from rates. For example, utilities complain that FERC takes too long to rule on applications to dispose of facilities, of the type that utilities will have to file in order to form RTOs. Congress, in theory, can legislate an end to delay. Better yet, FERC itself can and should accelerate the process. I think we should put a provision into the Final RTO Rule that we will act on those applications within six months. FERC should use its existing discretion. Moreover, the August 4th draft would have eliminated FERC review of mergers. Currently, FERC's review of mergers could delay formation of RTOs. The August 4th draft had a good idea.

We hear clamor in another area: reliability. The argument goes that competition, meaning cost cutting, will slight the long-term investment in reliability. Therefore, critics caution, Congress must step in. I disagree completely that the two considerations must pull in different directions. I also disagree completely that Congress must take the lead. Here, again, FERC has authority to act.

Remember, in a business, the management looks at profit margins, not low cost. Earning a profit entails quality service; or, more accurately, several layers of quality service, depending on how much the consumer wants to pay. In any event, entrepreneurs must meet minimum criteria. In most instances, take electric appliances, for example, a close relative to the electric industry, Underwriters Laboratory, a private group, sets standards that companies adhere to without the need for one word of legislation. Why? Society makes it in the interest of appliance manufacturers to do so.

We can supplement performance based rates to include reliability, another word for quality. When I served as a Commissioner and Chairman in Mississippi, we included the minimum reliability as one measure of performance on which the utilities earned profit. We at the FERC could adopt the same measure as part of rate plans under section 205 of the Federal Power Act. Adding reliability to performance based plans means quicker action than having a self-regulating organization establish standards with appeals to FERC because we would make the utility's economic interest coincide with the public interest. Here, again, FERC has existing authority to act.

Furthermore, taking the regulatory approach makes meeting the goal more difficult. Coercion means utilities would resist, at the Commission and in the courts of appeals. If we compensate companies for their additional risk taking and bold action, we align the economic interest and the public interest. We would not need to discuss authority for FERC or legal issues of the type this hearing will debate. Again, as I wrote in my article, "FERC must let [the ripe fruit] fall from the tree."

I said at the outset of this testimony that existing institutions can deal with municipal utilities and cooperatives. Having served in the Mississippi Legislature, I know that cities, counties and districts exist as creatures of the state. Under the Mississippi Constitution, as in other states, the Legislature exercises tight control over the affairs of political bodies within its boundaries. The Legislature must authorize taxes and expansion of municipalities into new areas. With that leverage, state legislatures can enact laws to place public transmission agencies on the same track as investor owned.

FERC, of course, might think it can do it too, and, under the Barton Bill, we would have the jurisdiction. I think, however, that the elected legislatures, closer and more accountable to the people, know better than FERC, how to accomplish restructuring in their areas. The August 4th draft directed the FERC to give "maximum practicable deference" to state commissions, which would be preferable to mere deference. After all, we all agree that low prices to the customer remains the paramount end. Restructuring forms but a means to that end.

I see no need for legislating on the cooperatives. The strong economy and changes in the law give cooperatives incentives to pay off their debts to the Rural Utilities Service. If this trend continues, as we have seen at FERC, many will become public utilities under FERC regulation. If FERC enacts incentives for transmission, more will volunteer. In this market of deregulated generation, cooperatives and municipals, with their local roots, will see their niche as serving the people's need for transmission. I do not think that they could compete nationally as generators with the large investor owned companies. As I have said repeatedly, if FERC incents, they will come. I think the municipals and cooperatives will, too.

Now I will turn what, to me, form the major features of the Bill: incentives and flexibility. The approach the proposed legislation takes holds great interest to me. From the beginning of my tenure at FERC, I have spoken out forcefully in favor of encouragement and incentives and against mandates. Even with my vision of an independent transmission company as the model for RTOs, I favor allowing other forms of organizations to exist. I would just give incentives to RTOs that exhibit true independence.

I noted with approval the reports that this draft of the Bill rejects FERC mandates and favors incentives. When I read the draft I saw that, in fact, the authority for FERC to mandate RTOs fell away, and the Bill directs FERC to offer incentives. So far, so good.

The fine, print, however, makes me wonder about the direction the Bill is heading. Section 103 requires all transmitting utilities to establish or join an RTO, albeit of their own design by 2003. Paragraph (2) establishes criteria and wisely says that independence encompasses separation of control, but could include passive ownership and 10% voting control or lower. I agree with the idea that independence requires separation of legal control and tolerate passive ownership and 10% voting control. I acknowledge that 2003 extends by almost one year the deadline the RTO NOPR has for voluntary RTOs to begin operation.

I pause, however. Under the draft Bill, Congress, not FERC, mandates RTOs. For the industry, a mandate robs initiative, whether the compulsion comes from a law or from an administrative rule. Moreover, the draft requires FERC to consider existing transmission organizations in certifying RTOs. This prevents progress. The most ardent advocates of existing ISOs concede that these organizations represent, at best, a step toward the ultimate goal of true independence. In short, everyone agrees ISOs must evolve. This Bill freezes the *status quo* with existing ISOs. As I said at the outset, I would allow ISOs to exist, though I find them falling short of the RTO criterion of independence. Instead, I would clear the way toward the goal: truly independent transmission companies.

This leads to my next topic, incentives. Everyone knows I favor them. To work effectively, however, incentives must induce, not sugar coat compulsion. If Congress mandates RTOs, at best, you turn precisely designed economic measures that proponents must tie to specific results into rewards for obeying the law. At worst, you rob incentives of their meaning. We must ask ourselves, does the seller to a distress sale really negotiate the price?

Although I support incentives as providing proper direction and motive, I oppose an indiscriminate application of incentives. The draft Bill requires incentives for existing ISOs, rewards they do not need and that I would deny them. I said earlier exiting ISOs fail the independence test. Besides that, why increase rates for past conduct that occurred anyway? Some of the past conduct occurred under the compulsion of law. Companies deserve no reward for obeying the law. I wonder how to design proper incentives for past conduct. As with grandfather provisions for existing ISOs as RTOs, giving the same incentives to ISOs defeats the purpose of restructuring. Since ISOs must evolve into better organizations, we should provide the incentive only for the better organizations. Once we freeze ISOs, we have stopped in its tracks the evolution of the industry.

You could solve the problem by inserting a sunset date for ISOs to become truly independent. The draft Bill has nothing in it. If you wanted to enact something and chose a date (without being arbitrary), you should save the incentives for organizations that get to the end state earlier. On that score, I note that this Bill removed the date for retail competition, a step that I applaud.

If I may, please let me conclude with a discussion of one more provision that I think illustrates the distinction between my approach and that of the draft Bill. I agree with the goal, I raise questions about the means.

The draft Bill enmeshes the government in reliability to a greater extent than now, or necessary. FERC will have to certificate a reliability organization, hear appeals of controversies over reliability and establish mandatory rules. The model for this comes from the Securities and Exchange Commission with self-regulating stock exchanges. I dare say I am not an expert in stocks, but I can see something like that for a market in which unsophisticated and unsuspecting investors may lose their life savings.

Here, however, we have a better solution. We deal with sophisticated businesses. This reality allows for performance based rates as the insurer of reliable operations. Reliability has two components: safety and adequate capacity. Both of these, or the lack of them, affect the bottom line of a business. My suggestion then is to create a climate in which that occurs in transmission. Specifically, tie profits to performance – safe performance and an adequate number of transactions. Give transmission companies business plans to meet. Favorable earnings result from good results, losses from poor management. Clearly, we don't need legislation to do that. FERC has the authority to institute performance based rates. We did it in Mississippi. The Public Service Commission put three criteria into the final plans. Two of them fall directly under the category of reliability, and one indirectly. Earnings depended on the number and duration of interruptions, customer satisfaction (using actual complaints) and price into which we factored sales transactions. The companies figured out how to set and meet reserve margins, safety standards and capacity goals. We aligned the private economic interest with the public interest. FERC can do that now. We said in the RTO NOPR that we would consider it. Why enmesh FERC in details that it has no expertise or resources to devote? Instead of engaging in proceedings lasting years and years debating reserve margins and capacity needs, FERC, every few years, would review performance plans and fine tune them.

Congress should leave it up to FERC to get restructuring right. I think we must treat transmission as a business. Regulation treats transmission as politics, with committees, debates and compromises and as law with complaints, litigation and appeals. Treating transmission as a business means rescinding regulations that prevent business people from operating transmission as a viable enterprise. Your predecessors gave FERC broad authority to establish just and reasonable rates. The courts have given deference to our expertise. Let us use that tool and let competition flourish. In short, let FERC let go.

Thank you.

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Thank you for the opportunity to testify before you on the Electricity Competition and Reliability Act of 1999.

Restructuring boils down to four parts: incentives, performance based rates, contracts and FERC letting go. If we all agree, as I think we do, that electricity has progressed past a natural monopoly into a business, regulation must turn from law and rules, to economics and performance goals. Incentives involve removing the obstacles that regulation, having outlived its roots, create in the way of market forces taking over. FERC can and should remove them under existing authority.

Performance based rates mean transforming a regime of rules into a business plan that will affect the utility's profits, while affecting choices for ratepayers. Affected parties agree on the goals the transmission company must meet and back it up by designing the enterprise's profit picture. FERC can and should do that under existing authority.

Lastly, FERC must let go. When prices rise, we shouldn't jump and cry market power, without evidence. Experience in the market teaches us that high prices bring more supplies or lower demand and correct the market. If we want a market, we must let one develop. FERC can do that. FERC should do that.